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UNCLAS SECTION 01 OF 03 TAIPEI 002546

SIPDIS

STATE PLEASE PASS AIT/W AND USTR

STATE FOR EAP/RSP/TC, EAP/EP AND EB/IFD/OIA

USTR FOR SCOTT KI

USDOC FOR 4420/USFCS/OCEA/EAP/LDROKER  
USDOC FOR 3132/USFCS/OIO/EAP/ADAVENPORT

TREASURY FOR OASIA/ZELIKOW AND WISNER

TREASURY PLEASE PASS TO OCC/AMCMAHON

TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF  
GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

E.O. 12958: N/A

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SUBJECT: TAIWAN: NOT ENOUGH FUNDS FOR BANK RESOLUTION

1. (U) Summary: On May 31, 2005, the Legislative Yuan (LY) provided additional funding to extend the life of the Financial Reconstruction Fund (FRF). Much of the additional funding is earmarked for specific uses, including a bailout of shareholders in a credit association favored by the opposition Party. The remaining funds are unlikely to be sufficient to resolve existing problems at financial institutions. Prior to July 10 the Financial Supervisory Commission must designate institutions eligible for FRF funding. This deadline may encourage some additional bank consolidation. On a positive note, this same legislation caps the size of accounts eligible for deposit insurance coverage. This move may instill some market discipline in the banking sector. End Summary.

#### New Funds for Bank Resolution

2. (U) On May 31, 2005, the LY passed amendments to provide additional funding of NT\$110 billion to temporarily extend the life of the FRF. First established in 2002 with NT\$140 billion, the FRF was to address Taiwan's banking crises of 2001, but has been plagued by under funding and legislators' efforts to direct support to particular financial institutions. Three quarters of the additional funding, barely ten percent of the NT\$1.05 trillion requested by authorities in 2002, is already designated for specific uses. The remainder is well short of funding needed to resolve existing problems at financial institutions. Prior to July 10 the Financial Supervisory Commission (FSC) must designate institutions eligible for FRF funding.

#### Lingering Financial Problems

3. (U) Taiwan's widespread banking crisis in 2001 caused severe losses in a wide range of institutions, including banks and credit associations. Four years later, many of these losses have yet to be resolved. The insolvent Fengshang Credit Cooperative Association (FCCA) is a case in point. Under procedures and criteria established by Taiwan banking officials, FCCA shareholders (and those of other insolvent institutions) would not receive compensation for losses. Depositors, on the other hand, are guaranteed to receive full compensation for all deposits in the banking system in the event of an institution being shut down for insolvency. Opposition Nationalist (KMT) Party legislators have repeatedly stalled efforts to increase funding for the FRF until compensation is provided for FCCA shareholders. The May 31 legislation provides NT\$500 million compensation specifically for FCCA shareholders. In April 2004, FCCA had a non-performing loan (NPL) ratio of 45% and negative net worth and was placed in receivership. In July 2004, ChinaTrust Commercial Bank won a bid to take over FCCA and received NT\$1.1 billion from the FRF as part of the deal.

4. (U) Besides the NT\$500 million set aside for the FCCA shareholders, the amendments specify that NT\$58 billion is to be used to finalize the last bank resolution undertaken by the FRF. Chong Shing Bank (CSB) was placed in receivership in March 2001 and had outstanding liabilities of NT\$58 billion in inter-bank loans. In December 2004, the Union Commercial Bank (UCB) bid on and won the right to take over CSB. FRF paid UCB NT\$7 billion in the deal, exhausting FRF's original funding of NT\$140 billion. The NT\$58 billion in outstanding inter-bank loans remained on the books of CSB (now part of UCB) and the creditor banks until such time as the FRF receives additional funding and disburses payment.

15. (U) Another NT\$22 billion of the FRF's additional funding is earmarked for resolving ongoing financial issues at the credit arms of Farmers and Fishermen Associations (FAs). There are 278 FA credit arms operating 1,146 offices island-wide. FA credit arms are small, accounting for only three percent of Taiwan's lending markets. However, their NPL ratios average 14%, much higher than the 3.7% for domestic banks and the 3.3% for credit cooperative associations. Taken together, the designated amounts of NT\$500 million for FCCA, NT\$58 billion for CSB and NT\$22 billion for FA credit arms, total to NT\$80.5 billion. The FRF is thus left with NT\$29.5 billion to tackle the financial losses left over from the 2001 banking crisis.

#### Funding Insufficient

16. (U) Taiwan's banking community tells AIT/T that NT\$29.5 billion is insufficient to deal with financial institutions that report higher than average NPL ratios and lower than average capital-adequacy ratios. However, there is consensus that "it is better than nothing."

17. (SBU) AIT/T believes that there are at least seven institutions requiring immediate attention, including four domestic banks, two credit cooperative associations, and a trust company. These seven institutions have NPL ratios above 10% and capital adequacy ratios below 10% as of March 2005. Their combined NPLs totaled NT\$82 billion, far more than NT\$29.5 billion available to FRF. These problem institutions are likely to be designated for assistance under the requirements of the May 31 legislation. Following designation of an institution, FRF involvement in a designated institution can go well beyond the July 10 deadline.

18. (U) Without sufficient funding for the FRF, we expect Taiwan authorities will urge problem institutions to improve their quality by increasing capital or merging with better-quality banking institutions. There could be efforts to inject new at-risk capital and increased merger activities prior to the July 10 deadline.

#### FRF Out of Business

19. (U) FRF will pay non-deposit liabilities, such as inter-bank loans, only for institutions put under receivership prior to July 10. FRF compensation must be paid by July 31, 2005.

#### Deposit Insurance Capped at NT\$1 million

10. (U) One provision of the May 31 legislation seeks to mitigate future banking problems. Taiwan's Central Deposit Insurance Corporation (CDIC) currently provides unlimited coverage for bank deposits. Starting from July 11, 2005, CDIC will only cover up to NT\$1 million per depositor. The LY and banking regulators hope that by reducing the level of insurance coverage, bank customers will be more stringent in choosing a bank. Banks with bad reputations could suffer a loss of deposits and thus face greater pressure to consider merging with other, stronger, banks.

#### FRF Financing Mechanism Extended

11. (U) Much of the FRF funding has come from extending the collection period for the Gross Business Receipt Tax (GBRT). This tax, formerly set at 5%, had been due to expire. The original FRF legislation directed that the FRF funding would come from a temporary extension of the GBRT, which would be set at 2%. The extended 2% GBRT will now continue for an additional four years until December 2010. The additional funds collected between 2006 and 2010 will go to the CDIC and increase its deposit insurance reserve.

#### Comment

12. (SBU): The now four-year long saga of the FRF illustrates a longstanding political struggle between the ruling Democratic Progressive Party (DPP) and the opposition parties, in particular the KMT. By delaying funding for the FRF since 2002, the opposition has continuously stymied efforts to resolve the banking crisis of 2001. Insolvent financial institutions that should have been shut down or sold off long ago have been allowed to continue doing business. The LY has declared victory by establishing an end date for the FRF, but has provided far too little in funding to handle the outstanding losses. The end result is that resolving these losses will drag on for some time. The longer it takes for resolution, the less pressure individual bankers will feel to make needed reforms and the longer it will take for Taiwan to develop an efficient banking sector. End Comment.

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